Capitalising on Remittances for Financial Development - Examples of Regulations and Policies

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Abstract

While up to now research on remittances has strongly concentrated on questions linked to poverty reduction and the use of remittances, we emphasize the potential impact of remittances on financial sector development. We base our research on the assumption that the impact of remittances on the financial sector depends on several factors, which can be governed through different regulations and policies. We map different policy options and present examples from the Latin American context which potentially contribute to the goal of financial development.

Keywords: Remittances, Financial Development, Policies

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Introduction

Remittances – the money that migrants send home, usually to their families who have stayed behind – have steadily increased since the mid-1980s. Officially registered remittances reached an estimated volume of US$206 billion in 2006, compared to US$19.6 billion in 1985 (World Development Indicators 2006, Ratha 2007). They have been the second most important source of external finance for developing countries, being twice the amount of official development aid and almost as much as foreign direct investment. In absolute terms, large developing countries such as India, China, Mexico, and the Philippines receive the largest shares of remittances in the world. However, in relative terms, small and poor countries tend to be much more dependent on remittances. A ratio of remittances to GDP of above 15 or 20% is not unusual for many countries with large diasporas.

Research on remittances so far has mainly focused on their impact on reducing poverty (Adams/Page 2006), the creation of growth through multiplier effects (Glytsos 2002, Durand et al. 1996), their effects on inequality in remittance-receiving countries (Acosta et al. 2008, Koechlin/León 2006, Jones 1988), a possible loss in international competitiveness through the appreciation of exchange rates (Acosta et al. 2007, Amuedo-Dorantes/Pozo 2004, Loser et al. 2006) as well as moral hazard behaviour among remittance receivers (Chami et al. 2003). A couple of studies also have addressed the impact of remittances on human capital as well as on entrepreneurship among migrant-families (Adams 1991, Cox/Ureta 2003, Goerlich et al. 2007, Woodruff/Zenteno 2001). Recently, a number of studies also have addressed the impact of remittances on the capital accounts of remittance-receiving countries (Apaa-Okello/Aguyo 2006, Buch et al. 2002, Bugamelli/Paternò 2005; Sayan 2006). Because capital usually flows into a country in good times and out of a country in bad times, private capital has been pro-cyclical and has intensified boom-bust cycles in emerging markets. Remittances behave differently. While they function as an insurance against adverse economic conditions at the microeconomic level, they also help to stabilise the balance of payments at the macroeconomic level. As such, remittances can play a strategic role in the prevention of financial crises.

Our approach differs from existing studies on remittances by focusing on the indirect development effects of remittances via the financial sector. Our hypothesis is that remittances are conducive to financial sector development, provided that certain conditions are given. Furthermore, we assume that these conditions can be governed through multiple forms of formal or informal regulations, including governmental and non-governmental as well as national and transnational actors.

The paper is organised as follows: As a first step, we summarise the state of research on financial sector development through remittances and describe the conditions under which this can occur. The second part of the paper presents different remittance policies which are likely to contribute to a positive impact of remittances on financial development. Examples are taken from three heavily remittance-dependent Latin American countries: Mexico, El Salvador, and the Dominican Republic.

Financial Development through Remittances: A Neglected Research Field

Developing countries typically suffer from weakly developed financial markets and a low degree of monetisation of the economy, measured as a low ratio of credit to GDP and a low ratio of the monetary aggregates M2 or M3 to GDP. A large proportion of the population and typically the small and micro enterprises of the informal sector have no access to bank credit and thus operate outside the financial sector, with low capital intensity and low productivity. Empirical studies confirm that a relative increase in savings and credit is associated with an increase in growth and per capita income (Beck et al. 2000a, 2000b), while weakly developed financial markets limit the process of capital accumulation and hinder economic development.

Few studies have so far explicitly addressed the relationship between remittances and the development of the domestic financial sector, with the notable exceptions of Aggarwal et al. (2006), Fajnzylber/López (2007), Giuliano et al. (2006) and Mundaca (2005). Mundaca and Giuliano et al. differ in their approach to measuring the link between remittances, financial development, and growth. Mundaca finds that in Central America, Mexico, and the Dominican Republic the impact of remittances on growth is stronger when the indirect effect on growth via an extension of domestic credit is also taken into account. In other words, remittances have a stronger effect on growth in those countries where a functioning banking system exists. Giuliano et al. arrive at opposite empirical results in a cross-country comparison, saying that the impact of remittances on growth is, on average, higher in those countries where the financial sector is weak. Their argument for this surprising result is that in countries with weakly developed financial markets, remittances can compensate for a lack of access to credit. This leads to higher spending on investment and, consequently, higher growth. However, the findings of Giuliano et al. may be misleading, as they do not take into account the existence of informal remittances. The proportion of remittances sent through informal channels tends to be much higher in countries with weakly developed financial markets (Freund/Spatafora 2005, De Luna Martínez 2005). A series of African countries are among those with the highest proportion of informal remittances, while East Asia and the more developed Latin American countries such as Mexico have a relatively high ratio of formally transferred remittances to total remittances (Freund/Spatafora 2005). Consequently, Giuliano et al. may overestimate the growth effect of remittances in countries with weak financial markets. This is a good example of the difficulties associated with econometric studies based on high and shifting proportions of informal remittances that are not accounted for in the statistics of central banks. Improving remittance data is therefore a challenge for future research.

Aggarwal et al. (2006) show in a cross-country regression that an increase in remittances is positively correlated with an increase in banking deposits and, albeit to a lesser degree, with the volume of credit. The latter is also confirmed by Fajnzylber and López (2007), who stress the importance of differences between countries in the degree of correlation between remittances and credit. Aggarwal et al. conclude that their findings provide strong support for the notion that remittances promote financial development in developing countries, though they recognise that they are not able to give a definite answer to the question of causality: It is also possible that financial development leads to more – and more formalised – remittances and not vice versa. Also, they do not claim general validity for their findings, because individual countries may have experiences that differ from the aggregate results they present (Aggarwal et al. 2006: 20). Nevertheless, the study from Aggarwal et al. provides a good starting point for a closer examination of the link between remittances and financial sector development at the country level.

Linking remittances with banking services has positive effects on saving and investment

Important conditions for the contribution of remittances to financial sector development are the "formalisation" and the "bancarisation" of those flows. For many migrant families, sending remittances through formal channels is an important first contact with the formal financial sector. However, financial development requires a step further than just the formalisation of remittances. Remittances entering the country through MTO or post offices are paid in cash and neither the sender nor the receiver of remittances must necessarily hold a bank account. In contrast, access to banking services opens up the option of monetary savings instead of real savings or immediate consumption, from the remittance receiver's perspective. Furthermore, running a bank account with regular payment receipts may increase access to credit and other financial services. At the macroeconomic level, this may have positive effects on monetary saving and investment. Savings that are kept in bank accounts are available for investment elsewhere and can be channelled to where they earn the highest return, for example, where they have the highest productivity. Where migrants have no access to banking services, saving often takes the form of acquisition of real assets such as land or housing which may not be used productively. This can lead to a speculative increase in prices, resulting in limited investment opportunities at the microeconomic and the macroeconomic level.

Stiglitz and Weiss (1981) have shown how transaction costs and information asymmetries lead to credit rationing, and thus prevent parts of the population from accessing banking services. When individual sums are low, transaction costs are high, meaning that banks do not offer services to low-income groups, especially when they work in the informal sector and do not own assets that banks would accept as collateral for credit. According to data of the Inter-American Development Bank, only one out of ten people in Latin America owns a bank account, while in the USA nine out of ten people own a bank account (Bate et al. 2004). The access of remittance receivers to bank accounts is only slightly higher than the average, with important differences between countries (Fajnzylber/López 2007; Orozco 2006). Additionally, the fact that remittances are only moderately correlated with an increase in credit (Aggarwal et al. 2006, Fajnzylber/López 2007) could point to the fact that remittance receivers are subject to the typical problems of information asymmetries and transaction costs or to the possibility that remittances substitute credits. The unsatisfied demand for financial services has been confirmed by surveys among migrants and their families in El Salvador and Bolivia (Jaramillo 2005).

Remittances and Financial Development – Examples of Regulations and Policies

Since policymakers and researchers have realised the relevance of remittances for the receiving countries, they have been developing policy options to leverage the development potential of those financial flows. However, due to the fact that remittances are private capital flows at first glance it seems rather difficult to define government policies that could enhance their positive impacts. Despite of this, while scholars now agree that states should desist from implementing *direct* policy intervention – for example, the imposition of a tax in order to divert funds to public budgets – they also emphasise that quite a lot can be done to increase the development impact of remittance transfers through *indirect* policy interventions (Fajnzylber/López 2007: 47; GCIM 2005: 26f; Terry 2005: 12). However, those options are limited by the fact that data on remittances are still often not comprehensive enough to draw general conclusions for policy recommendations (Orozco/ Wilson 2005: 385).

Although there is more and more literature dealing with policies to increase the developmental impact of remittances at a general level (Carling 2004; CPSS/WB 2007; De Luna Martínez 2005; GCIM 2005; IAD 2007; Orozco 2004; Orozco/Fedewa 2006; Orozco/Wilson 2005; Page/Plaza 2005; Terry 2005), there are few detailed country and/or case studies on existing remittance policies. Also, policy options for remittances have, to date, rarely been studied in a systematic way. Remittance-related policies hitherto realised can be roughly divided into four groups: a) diaspora policies that try to influence remittance flows in a rather indirect manner, b) transfer cost reduction and improvement of payment systems, c) formalisation of flows and improvement of access to financial services for the 'unbanked' (often referred to as 'financial inclusion'), and d) the channelling of remittances towards 'productive' or 'non-consumptive' use[1].

In recent years there have also been several initiatives to tackle the growing importance of remittances at the international level: The G8 states concluded at their summit at Sea Island in 2004 that international cooperation was necessary to reduce the cost of sending remittances.[2] Moreover, a series of initiatives from international financial institutions, such as the World Bank and the

[1] It has to be noted, however, that the distinction between 'productive use' or 'investment' of remittances and 'consumptive use' is far from clear. In the following, we don't treat policies aiming at 'productive use' because they are not related directly related to financial development and macroeconomic stabilization.

[2] One of the following actions was the creation of a task force consisting of members from international financial institutions such as the World Bank as well as central bankers from both sending and receiving countries. The recommendations of the task force were published in 2007 in the document 'General principles for international remittance services' (CPSS/WB 2007; Terry 2005: 10f.).

Inter-American Development Bank, and international cooperation agencies have been dealing with the challenge of designing policies to improve the positive economic impacts of remittances (Orozco 2005: 28ff.). The growing international political interest in controlling remittance flows also increased in the wake of September 11: a range of new regulations emerged because of the fear of terrorist financing and money-laundering activities (Orozco 2007: 138; Hernández-Coss 2005: 1ff.). Policies, incentive schemes, and regulations in the field of remittances have often emerged at different policy levels and have not always been designed with a special focus on remittances. Some of them are forms of transnational cooperation of governmental, market, and civil society actors.

In the following paragraphs we present some examples of remittance policies related to financial sector development. Examples are taken from Mexico, El Salvador, and the Dominican Republic, which have all experienced significant labour migration to the United States for long periods of time, through which strong transnational ties have been established between the labour-sending and labour-receiving countries (Terry 2005: 7f). All three countries are highly remittance dependent[3], though the absolute sums and the relative weight of the remittance-flows differ between the three economies. Mexico is the country with the highest absolute flow of remittances in the region (and with one of the largest worldwide). El Salvador and the Dominican Republic have a high relative proportion of remittances in relation to GDP. Whereas in El Salvador remittances account for almost a fifth of the GDP, in the Dominican Republic this share lies around ten percent, in Mexico only around three. Mexico makes also a very interesting case because of its regional importance and its often pioneering role in terms of remittance-related policies. The United States is the main migration destiny for all of them and also the main remittance-sending country. To a considerable extent, the migrants move without the required documentation, which means that the flows take place through informal channels where the capacities of states to tackle the phenomenon are rather restricted.

Maintaining remittance flows through “diaspora engagement”

One strand of polices which intends to indirectly increase and stabilise remittances could be summarised as ‘diaspora engagement policies’ (Gamlen 2006: 3). Although such goals are not stated explicitly, it can be assumed that these policies are supposed to contribute to high remittances-flows and to increase transfers in bad times in order to balance income losses at the family level. One of the measures to maintain close links between migrants and their home country with the indirect effect of keeping remittance flows high is the right of dual nationality (Gamlen 2006: 10), that is guaranteed by Mexico and the Dominican Republic and partly by El Salvador (Vono de Vilhena 2006).

Many strongly remittance-dependent countries also have created special governmental institutions for its diaspora engagement policies. The Salvadorian government has institutionalized its diaspora policy creating the General Directorate for the Communities Abroad (*Dirección General de Atención a la Comunidad en el Exterior*, DGACE) as part of the Ministry of Foreign Affairs in 2000. With the aim of upgrading the institutional status of the diaspora policy, in 2004 additionally a special Vice-Ministry for Salvadorians Abroad (*Viceministerio de Relaciones Exteriores para los Salvadoreños en el Exterior*) was created. The DGACE organizes its activities along three main lines: cultural, economic and social programs. Whereas it doesn’t realize special policies regarding remittances, so does the Mexican Institute for the Mexicans Abroad (*Instituto de los Mexicanos en el Exterior,* IME), which is also part of the Ministry of Foreign Affairs. The IME offers a wider range of services than the DGACE, among others in the education and health sector, and recently it has also started to realize a range of activities related to remittances. In this field it mainly coordi-

[3] The International Monetary Fund defines an economy as remittance dependent when the critical percentage of remittances related to the GDP is greater than one percent (IMF

nates and informs about programs and policies of other governmental institutions and seeks to promote the development of further services for the migrant population.[4] In the Dominican Republic there are so called Consultative Councils of the Presidency of the Dominicans Abroad (*Consejos Consultivos de la Presidencia de los Dominicanos en el Exterior*), whose creation has been justified with the importance of the economic contributions of the emigrated population.[5]

Reducing costs for sending remittances

Reducing transfer costs can have a positive effect on the amount of money reaching the beneficiaries. If a migrant's budget allows him to send a fixed amount per month, then a lower transfer fee results in more money reaching his family. Countries have undertaken various efforts to reduce the costs of sending money home. Cost reduction can be realised through various approaches, for example, enhancing competition in the remittance market, improving payment systems, and increasing transparency (Fajnzylber/López 2007: 52ff.)

An example of the improvement of payment systems in the US-Mexican case is the bilateral agreement between the Federal Reserve Bank of Atlanta and the Mexican central bank which implied the coordination of their respective payment systems. Through this program, called '*Directo a México*', the existing payment infrastructure of both countries is connected, thus lowering the costs of transfers for payments from US bank accounts to Mexican banks accounts (Hernández-Coss 2005: 23f). Originally created for the transfer of pension payments to Mexico, this mechanism is now promoted especially for remittances transfers at one of the lowest fees in this bilateral corridor. One reason for the low cost is the usage of the FIX - the inter bank exchange rate – minus

2005: 76).

4 http://www.ime.gob.mx/.

5 http://www.ccpde.gov.do/default.asp.

a small spread (0,21%) as reference exchange rate for the transaction. MTO in contrast usually apply less favourable exchange rates, thereby often elevating transfer costs considerably. In the Salvadorian and Dominican cases, similar cooperation agreements with the United States do not exist. El Salvador has not yet established a unique paying system for the whole banking sector itself, which is a condition for connecting payment systems internationally.

Another measure concerning transfer costs in the Mexican case was the creation of an internet platform called *Calculadora de Remesas* (remittances calculator). This information service was launched by the national commission for the protection of consumer rights in the area of financial services (CONDUSEF). It allows the remittance senders to compare the transfer fees of a wide range of transfer companies operating in the market, who themselves are responsible for the actualisation of the data base. The internet platform provides information on fees according to the amount, the origin and the destination of the money transfer. Furthermore, it informs on the proximity of the respective bank or MTO branches to the location of both the sender and the receiver.[6]

The various efforts undertaken with the aim of reducing transfer costs have contributed to the fact that the US-Mexican remittance-flow corridor is now at quite an advanced stage in the process of shifting from informal to formal transfer systems (Hernández-Coss 2005: 11).

Improving access to the financial system for remittance senders and receivers

A considerable challenge for better capitalising on remittances is the fact that many migrant families, that is, remittance senders and receivers, lack access to financial services. Remittances can be a point of entry to the formal financial system for the 'unbanked', giving them access to bank accounts and other fi-

[6] http://portalif.condusef.gob.mx:8000/Remesamex/home.jsp.

nancial products such as consumer loans, mortgages, life and non-life insurance products and pensions (Terry 2005: 11f; De Luna Martínez 2005: 20).[7]

On the sending side, undocumented migrants often lack appropriate documentation to accede money transfer services, especially those offered by institutions of the formal financial sector. In the United States a large number of Latin American immigrants live there without documentation. In this context, governmental initiatives for the quasi-formalisation of migrants are ways of improving the access of migrants to the formal financial sector. The Mexican consulates, for instance, issue an identification document, the so-called '*Matrícula Consular de Alta Seguridad*' (MCAS). While the consulates have been issuing an identification document for Mexicans abroad already for more than 130 years, the MCAS has been launched in 2003 with a range of security features to prevent forgery. Despite of immigration critics that see in this document a subversion of the US immigration system and call it an "ID for illegals" (Dinerstein 2003), this alternative form of documentation is now accepted by a wide range of banks and other institutions in the United States, thus granting access to financial services, including the sending of remittances, to undocumented migrants (Hernández-Coss 2005: 11).

On the receiving side, especially the possibility of transfers through Microfinance-Institutions (MFI) seems promising for the improvement of financial inclusion and thereby the development of the financial sector in terms of both depth and breadth. That is because MFI are often located in areas where traditional banks aren't present and because they have considerable experience serving low-income clients that are often also the ones that receive remittances (Jaramillo 2005: 133f.).In this context, for instance, remittances could serve as collateral for credits. An assumed problem in linking remittances with financial services is that MFI are not always authorised to realise foreign ex-

[7] In fact, remittance recipients usually demonstrate higher levels of account holding than the average population. In Mexico, which shows one of the lowest levels of banking penetration in the Latin American Region, 29% of remittance receivers hold bank accounts compared to 28% of non-receivers. While in this case the difference is not that marked, in El

change transactions – even if this problem may be overcome by cooperation with financial institutions authorised and actively engaged in international financial transfers. Moreover, the scope and quality of MFI differ significantly among countries (Conger 2001).

In the Mexican case, a prominent attempt of improving migrants' families' access to financial services is the so-called '*Red de la Gente*' (Network of the People). This network was founded by the Mexican national development bank BANSEFI (*Banco de Ahorro Nacional y Servicios Financieros*) and includes over 180 credit unions and other MFI with more than 1600 branches.[8] Cooperating with various US-based MTO, *L@Red de la Gente* offers remittance-based services in Mexican rural and urban areas with low incomes and high migration density which are often not covered by the official banking system (Orozco/Fedewa 2006: 17; Orozco 2005: 21). A new initiative of the *Red* to foster the bancarisation of its clients is the so called "Beneficiary Account Registration" (BAR) mechanism through which a remittance-sender in the US can open a bank account in the name of a recipient family member in a credit union branch in Mexico. The receiver then has to formalize the account personally when receiving the remittances.[9]

In El Salvador there is no governmental initiative of that type. However, in the absence of a state led program, there are market or civil society driven experiences with similar motivations and presumably similar results. The Federation of Associations of Savings and Credit Cooperatives (*Federación de Asociaciones Cooperativas de Ahorro y Crédito* de El Salvador, FEDECACES) for example offers remittance services to its clients since 1998. It cooperates with a group of US based MTO and channels money transfers directly to its branches. Receivers have the option to join one of the cooperatives opening

Salvador the respective shares are 31% and 19% and in the Dominican Republic they are 66% and 58% (Orozco 2006: 5).

[8] http://www.lareddelagente.com.mx/pdf/documentos_de_interes/comunicados/2008/V_conv0508.pdf.

[9] http://www.directoamexico.com/en/lared.html.

an account and/or get access to other financial products like loans or insurances.[10]

In the Dominican Republic, there are initial projects connecting remittances with financial services, but in general MFI have not been very active in the remittance market up to now, among other things, due to capacity and regulatory constraints (Suki 2004: 47).

Conclusion

Within the growing research on workers' remittances, the impact of remittances on financial development, as well as the effectiveness of remittance-oriented policies in meeting these goals, has only recently gained attention. Besides a small number of cross-country studies, there is a lack of analytical and empirical work that is based on country studies and a systematic comparison of policies. In this article, we have presented an overview of the most recent and useful research, hypotheses on the potential links between remittances and financial development, and some examples of policies oriented – both intentionally and unintentionally – towards financial development through remittances.

In spite of the recent 'remittance euphoria', the positive development impact of remittances should not be taken for granted. Here, we have only focused on the impact of remittances on the financial sector, highlighting potential positive effects. Although remittances certainly do hold important potential for development, it is important to keep in mind that they can have also negative effects and that their impact depends on the specific context, as well as, for example, the quality of governance and the macroeconomic policies pursued by remittance-receiving states.

[10] Interview with Héctor Córdova, Executive Director of FEDECACES, 29th.of February 2008, San Salvador.

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